

**State of Rhode Island and Providence Plantations**  
**STATE INVESTMENT COMMISSION**

**Monthly Meeting August 26, 2009**

**A State Investment Commission (SIC) meeting was held in Room 135, State House, Providence, Rhode Island on Wednesday, August 26, 2009. The Treasurer called the meeting to order at 9:02 a.m.**

**Membership Roll Call. Present were: Ms. Rosemary Booth Gallogly, Mr. Michael Costello, Mr. Robert Gaudreau, Mr. Robert Giudici, Ms. Marcia Reback, Mr. Andrew Reilly, Mr. John Treat, and General Treasurer Frank T. Caprio. Also present were Ms. Sally Dowling, of Adler, Pollock, and Sheehan; Mr. David Ursillo, of Rodio & Ursillo, Legal Counsel to the Commission; Mr. Allan Emkin, and Mr. John Burns of Pension Consulting Alliance (PCA), General Policy Consultants to the Commission; Ms. Lisa Tyrrell of State Street Corporation; and Mr. Mark Dingley and other members of the Treasurer's staff. Dr. Robert McKenna was not present.**

**State Investment Commission Minutes. Treasurer Caprio entertained a motion for approval of the minutes for the meeting of June 24, 2009.**

**Ms. Gallogly moved, Mr. Treat seconded, and the subsequent motion passed. The following members voted in favor: Ms. Rosemary Booth Gallogly, Mr. Michael Costello, Mr. Robert Gaudreau, Mr. Robert Giudici, Ms. Marcia Reback, Mr. Andrew Reilly, Mr. John Treat, and General Treasurer Frank T. Caprio.**

**VOTED: To approve the Minutes of the June 24, 2009 monthly meeting.**

**General Consultant Report. Treasurer Caprio stated he contacted the board in anticipation of the report from PCA focusing on recommendations regarding a new asset allocation policy, and the potential new asset class of real return.**

**Mr. Burns ensued with information regarding asset allocation as detailed in the meeting material, Optimizations III. He highlighted some changes made based on prior board discussions: Treasury Inflation Protected Securities (TIPS) were moved into the real return asset class; the opportunistic portfolio has been taken out of this analysis because its omission makes the analysis much easier to understand and benchmark. Six optimizations were prepared by PCA and compared to the current portfolio on the basis of risk and return characteristics. He added further detail by breaking the different portfolios down by asset classes. Some optimizations demonstrated superior profiles. Initial findings suggest that adding the real return asset class reduces total fund volatility. The primary tradeoff is between real asset and fixed income, increasing flexibility and ability to structure the portfolio, and between moderate growth assets and growth-oriented assets. He pointed out that Portfolio #4 is PCA's recommendation.**

**The presentation shifted to policy allocation target ranges. Ranges or bands introduce an element of flexibility after policy is established.**

**The previous outcome, buy and hold up or down, is reduced through what Mr. Burns described as moderate flexibility. Bands would also enable us to take risk off the table (to some degree) or add some risk, depending on market conditions.**

**Mr. Costello inquired about the assessment of liquidity as it currently relates to the portfolio.**

**Mr. Burns replied that Mr. Goodreau provided the rationale for holding the current amount of cash; this included the need to meet all the anticipated liabilities (i.e. capital calls, balancing asset allocation) as well as a built in buffer. Liquidity is addressed, differently from a year ago, by placing a permanent 2% Cash allocation.**

**Mr. Emkin provided insight on the merits and drawbacks of holding cash in the context of different economic times.**

**Mr. Goodreau explained holding cash mitigates the unfortunate circumstance of forced liquidation, where the State might be forced to sell a potentially more profitable investment because the appropriate amount of cash wasn't on hand to cover commitments. Also, when active money managers were handling more funds they had an average of 1% to 3% of cash.**

**Ms. Booth Gallogy inquired about the current TIPS allocation and the proposed range guidelines.**

**Mr. Burns stated TIPS are currently 6.1% of the portfolio. He discussed how the current portfolio is structured without the Russell Overlay and how Russell brings the portfolio back within policy guidelines. Current bands are tight. With Russell, bands could be**

expanded or shrunk according to SIC policy decisions. However, the intent here is to define/open the discussion to what would be the tolerable bands.

Discussion followed among the members on the use and definition of bands.

Mr. Emkin clarified 'the range' is a management tool to reach the target. It is a risk control device based on board policy.

Mr. Burns discussed ranges and how establishing triggers allows for Russell to re-balance according to SIC policy.

Mr. Costello described how bands allow for a collar around asset classes and how this engenders discipline and doesn't let the market distort allocation.

Mr. Goodreau suggested there are situations in which this proposed structure would enhance control and the ability to manage. He commented on how the market could control the portfolio and possibly throw things out of whack. However, the alternative is that the board sets policy, essentially being proactive and enabling discretion.

Treasurer Caprio recommended advancing the discussion on standard deviation and the move to this new asset class (real return) that exhibits less volatility while still achieving a return above target. He asked that PCA re-run some of the analysis with certain guidelines.

Treasurer Caprio stated the private equity allocation in portfolio 4 is 9%. Currently we have

7.5% allocation. He asked for the rerun to keep private equity at 7.5 %

as the target and put the 1.5% into U. S. and non-U. S. equity.

Treasurer Caprio returned to the discussion topic of real return and TIPS.

Mr. Burns stated this will provide some protection against unanticipated inflation and provide some diversity in the form of asset allocation and a beta source.

Treasurer Caprio inquired about the options in today's market to invest in this asset class through an index type product if available; preferably a low risk way to invest in the asset class that would avoid consultants or fund managers. That would be an attractive option because of the avoidance of fees.

Ms. Reback expressed concerns over the infrastructure asset class; specifically, the privatization of existing public venues and employees losing jobs, benefits and pensions. She expressed interest in putting some criteria together to address her concerns.

Mr. Emkin responded by using previous PCA client-directed asset class and investment mandates. All relationships have been characterized by supporting fair labor practices. However, he mentioned that the decision is up to the SIC and that before a decision would be made, the commission could vote on policy guidelines.

Mr. Burns provided background information on the real return asset class. He mentioned that every investment in the portfolio has an expected inflation component built into the expected return and price. The key thing to be cognizant of is unanticipated inflation, or higher

than what was priced into the product. TIPS are the cleanest, purest investment that's tied directly into CPI, or the appropriate index. Real return asset class differs from real asset because Real assets are tangible, like timber. However, they all belong in the same bucket. Holding small amounts of many different real return class vehicles probably won't have the desired effect on the overall portfolio. In that light, Mr. Burns suggested that the SIC focus on the first few classes, at least initially, like Commodities and TIPS, which could be implemented quickly.

Mr. Emkin added that an educational opportunity would be made available to members of the SIC before recommendations to invest are made.

Ms. Reback stated that she thought Commodities, in general, were risky because you're predicting the future.

Mr. Emkin explained that while commodities have exhibited volatility, they have historically tracked inflation. He also explained the benefits of diversification though the return is not guaranteed.

The discussion concluded with the consultants suggesting that policy guidelines be implemented.

Treasurer Caprio requested materials on policy guidelines and best practices to be presented at the next meeting.

Mr. Emkin concluded by acknowledging the tough economic times have placed significant stress on state institutions. In response to this, he has announced a 10% fee reduction.

Treasurer Caprio thanked Mr. Emkin and noted that we will be seeking fee adjustments from our general partners.

**Legal Counsel Report. Legal Counsel had no report.**

**Cash Manager Report Treasurer Caprio remarked, in introduction, that in anticipation of revenue that will be collected in the latter part of the budget year, the State borrowed \$350M (TANS) about 2 wks ago at a rate of .52%. In the same period of time Illinois borrowed the same type of funds and they paid 1.1%. RI received the highest rating a state could get borrowing for that short-term funds. This rating is a result in part because of the financial management practices that Rosemary and her team performs and the work Vin does in the cash management area.**

**Mr. Izzo thanked Treasurer Caprio and proceeded with an update on the fee elimination created by the move into the passive portfolio for the pension fund. In the 4th quarter we saved approximately \$1.55M in fees over what we paid in previous quarters for active manager fees. Additionally there is \$350K received as a credit due to the transition. In total we saved almost \$2M in the 4th quarter of FY2009.**

**Regarding RI Short Term Cash Performance, Mr. Izzo asked the board to consider an increase to the ability to invest in collateralized deposits to the same level as money market investments (75% in total and 35% with one institution; the current allocation is 50% and 20%). The collateralized deposits are the highest performing part of our portfolio, and there is minimal risk due to 100% collateralization. The handout showed that collateralized deposits from January 1, 2009 to August 25, 2009 out-performed money market investments by 68**

**basis points. If we could have maximized the use of collateralized deposits from January to August, we would have earned an additional \$392K.**

**Mr. Giudici asked what we demand as the collateral on collateralized deposits.**

**Mr. Izzo replied we are demand 102% on deposit in treasury and agencies, and most of the banks we employ use BNY Mellon as the 3rd party custodian.**

**Treasurer Caprio asked Mr. Izzo to clarify an agency for the board.**

**Mr. Izzo replied that an agency could be any of the United States agency discount houses and U. S. Treasury.**

**Treasurer Caprio entertained a motion to allow the maximum for collateralized deposits to increase from 50% to 75%, and for the individual vendor maximum to go from 20% to 35% as we have with money markets. Ms. Gallogly moved. Mr. Giudici and Mr. Reilly seconded and the subsequent motion passed. The following members voted in favor: Ms. Rosemary Booth Gallogly, Mr. Michael Costello, Mr. Robert Gaudreau, Mr. Robert Giudici, Ms. Marcia Reback, Mr. Andrew Reilly, Mr. John Treat, and General Treasurer Frank T. Caprio.**

**VOTED: To allow the collateralized deposits' maximum to increase from 50% to 75% and the individual maximum vendor to go from 20% to 35%.**



**Chief Investment Officer Report. Mr. Goodreau informed the board that the portfolio is picking up good performance in all asset classes. The portfolio was up 5.5% in July though there still is real estate and private equity adjustments of almost 1% which will offset our gains. The bench mark for real estate and private equity is S & P 500 plus 300 basis points. Because of the accounting lag, it looks like we are under-performing our policy when in fact we are out-performing our policy by about 50 basis points. In publicly traded equities, bonds and liquid assets, the fund would have been up almost 14% for the year. We are up 7.581% for the year even when the re-adjustments for real estate and private equity are included.**

**Treasurer Caprio commented that our switch from active managers to the indexes during this unprecedented volatility in the markets has allowed us to fully participate in the markets' rise. News stories coming out now illustrate many active managers were defensive after the drop in March. Therefore as the market started to move to the up side many active managers were still in defensive positions and did not participate fully. Now they are forced to play catch up to the indexes.**

**Mr. Goodreau stated the Treasurer is on point that during this difficult time it is important to know we are fully participating. On aggregate return after expenses would have been behind based on how our former managers have performed.**

**He mentioned that what Mr. Izzo touched on earlier is only the beginning of cost savings, which is not our primary reason for the switch. The Treasurer pinpointed the issue in stating our primary**

focus is to have and maintain an efficient exposure, the by-product is the savings, which nevertheless it is real money for the fund.

In regard to the Russell program, he observed that it is measured against perfect implementation. During volatile markets this program gets more active, when we are out of balance the program will automatically start to work more. We have picked up 16 basis points of performance over the perfect implementation which is \$11.3M. It would have been difficult to perfectly implement due to time delay and the extreme volatility we experienced. The program has allowed us to manage the portfolio efficiently through a difficult period.

**Treasurer's Report** Treasurer Caprio confirmed the fee reduction initiative previously discussed – RI will embark on a very aggressive discussion with our partners to reduce fees. We think that there is momentum behind these discussions among institutional investors around the country and we should fully participate. We will continue to update the board going forward.

He highlighted the fee disclosure policy that PCA is drafting. This policy will require our partners to disclose to us, before we hire them, how they are spending their fee dollars.

Treasurer Caprio also stated the he is proud of the staff in his office for their outstanding work as they went through a very in depth review by some of the members of our local media. He feels the story that resulted was one that highlighted the strengths of the office and its transparency.

**New Business. There was no new business.**

**There being no new business, the Treasurer entertained a motion to adjourn. Ms. Reback moved, Mr. Treat seconded and the subsequent motion passed. The following members voted in favor: Ms. Rosemary Booth Gallogly, Mr. Michael Costello, Mr. Robert Gaudreau, Mr. Robert Giudici, Ms. Marcia Reback, Mr. Andrew Reilly, Mr. John Treat, and General Treasurer Frank T. Caprio.**

**VOTED: To adjourn the meeting.**

**There being no further business, the meeting was adjourned at 10:35AM.**

**Respectfully submitted,**

**Frank T. Caprio  
General Treasurer**